80-708

Docket No. .....

Supreme Court, U. S.
FILED
OCT 31 1980
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1980

ROCCO CATENA, on behalf of himself and the Certified Plaintiff Class,

Petitioner,

vs.

CAPITOL INDUSTRIES, INC., et al.,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

DAVID B. GOLD, ESQ.
PAUL F. BENNETT, ESQ.
GEORGE DONALDSON, ESQ.
JOHN W. ALLURED, ESQ.
DAVID B. GOLD, a Professional Law Corporation
120 Montgomery St.,
Suite 650
San Francisco, CA 94104
Telephone: (415) 981-2440

and

EDITH S. NEWMAN, ESQ.

Attorneys for Petitioner on behalf of himself and the Certified Plaintiff Class

SORG PRINTING COMPANY OF CALIFORNIA, 346 FIRST STREET, SAN FRANCISCO 94105

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	1
OPINIONS BELOW	3
JURISDICTIONAL STATEMENT	3
STATUTES, REGULATIONS AND RULES INVOLVED	3
STATEMENT OF THE CASE	4
A. Factual Background	4
1. Accounting for Sales Returns	10
2. Capitol's Accounting for Production Obsolescence	13
3. Capitol's Use of the Reserve for Cooperative Advertising Commitments	16
4. Capitol's Loans to Invictus	18
5. Holding Back Returns	21
6. Deferral of Convention Expenses	22
7. Standard Cost Adjustments	23
8. Capitol's Failure to Disclose Its Dependence on the Beatles and Glen Campbell	25

B. The District Court's Decisions 28

1. April 5, 1978 Memorandum of Decision 28

2. The May 13, 1976 Ruling 29

C. The Ninth Circuit's Decision 30

REASONS FOR GRANTING THE WRIT 32

A. Does Reckless Conduct Give Rise to Section 10(b) Liability, and, If It Does, Is "Good Faith" a Defense 34

B. The Decision Below Conflicts With The Decisions of Other Courts of Appeal as to the Definition of "Good Faith" in the Context of Rule 10b-5 Actions 46

C. The Decision Below Conflicts With The Decisions of Other Courts of Appeals as to the Applicability of the "Clearly Erroneous" Standard of Federal Rule of Civil Procedure 52(a) 54

D. The Decision Below Conflicts With the Decisions of the Second Circuit as to the Proper Interpretation of Federal Rule of Evidence 803(6) 60

CONCLUSION 65

TABLE OF AUTHORITIES

Cite	Pages
Aaron v. SEC, 100 S.Ct. 1945 (1980).....	35
Ayers v. Western Line Consolidated School District, 555 F.2d 1309 (5th Cir. 1977).....	56
Carter v. Stanton, 405 U.S. 669 (1972).....	55
Coleco Industries, Inc. v. Berman, 567 F.2d 569 (3d Cir. 1977).....	35
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).....	28, 31, 33, 34, 35, 38, 41, 42, 44, 53
First National Bank of Cincinnati v. Pepper, 547 F.2d 708 (2d Cir. 1976).....	56
First Virginia Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977).....	35, 48
Fleischman Distilling Corp. v. Maier Brewing Corp., 314 F.2d 149 (1963).....	59
Galena Oaks Corp. v. Scofield, 218 F.2d 217 (5th Cir. 1954).....	56
Hanson v. Aetna Life & Cas., 625 F.2d 573 (5th Cir.1980).....	55
In re Hygrade Envelope Corp., 366 F.2d 584 (2d Cir. 1966).....	56, 57
Kaiser-Frazer Corp. v. Otis Co., 195 F.2d 838 (2d Cir.1952).....	50

Korte v. New York, N.H. & H.R. Co., 191 F.2d 86 (2d Cir. 1951)... 62

Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973)..... 48

Mamiye Bros. v. Barber Steamship Lines, Inc., 360 F.2d 774 (2d Cir. 1966)..... 58

Marsbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979)..... 35

McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979)..... 48

Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978).....31, 35

Old Dutch Foods, Inc. v. DanDee Pretzel & Potato Chip Co., 477 F.2d 150 (6th Cir. 1973).....56, 57

Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978).. 35, 37, 38, 39, 41, 45, 48

Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1972)..... 51

SEC v. Falstaff Brewing Corp., [Current Volume] Fed.Sec.L.Rep. (CCH), ¶97,505 (D.C. Cir. 1980)... 42

Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977)..... 35, 39, 40, 41, 48

Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6 (1971)..... 51

United States v. Parke Davis, & Co., 362 U.S. 29 (1960)..... 55

United States v. Weingarden, 473 F.2d 454 (6th Cir. 1973)..... 56

Rules and Statutes

Judiciary and Judicial Procedure, 28 U.S.C. §1254(1)..... 31

Securities Exchange Act of 1934

§10(b) [15 U.S.C. §78j(b)]... 1, 3, 4, 5, 33, 34, 35, 36, 41, 43, 44, 47, 51

Rule 10b-5 [17 C.F.R. §240.10b-5] 1, 3, 4, 28, 32, 34, 35, 36, 45, 46, 47, 48, 50, 51

Federal Rules of Civil Procedure

Rule 52(a)..... 2, 3, 54

Federal Rules of Evidence

Rule 803(6).....4, 34, 60, 61, 62, 63, 64

Rule 803(24)..... 64

Miscellaneous

H.R. Rep.No. 1383, 73d Cong. 2d, Sess. 11 (1934)..... 52

Notes of Advisory Committee on Proposed Rules, U.S.C.A. 803(6), Pub. 1..... 63

Prosser, Law of Torts
(4th Ed. 1971)..... 38

Restatement (Second) of Torts
§500 (1965)..... 38

QUESTIONS PRESENTED

1. Where a public reporting company recklessly misrepresents or omits to state material facts to the investing public, does liability arise under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and if so, do defendants' professions of "good faith" constitute a defense to such reckless reporting practices?

2. Where a public reporting company knowingly or recklessly misrepresents or omits to state material facts to the investing public, does proof that the officers and directors of that company acted in "good faith" in managing the company's affairs insulate the company and its officers and directors from Rule 10b-5 liability to purchasers of the company's common stock?

3. When an appellate court reviews whether a defendant's conduct constitutes recklessness under Rule 10b-5, does the

"clearly erroneous standard" of Rule 52(a) of the Federal Rules of Civil Procedure apply?

4. Is a memorandum which is prepared by a public reporting company's independent auditor, which is sent to his superiors to guide them in their future dealings with respondent company's management, which relates to his observation of the respondent company's internal accounting and auditing standards and which bears directly on respondents' scienter admissible as an exception to the hearsay rule under the Federal Rules of Evidence?[1]

---

[1] The parties involved are (1) Petitioner Rocco M. Catena on behalf of himself and all persons who purchased the common stock of Capitol Industries between June 1, 1969 and December 31, 1971 and (2) Respondents Capitol Industries, Inc., Capitol Records, Inc., E.M.I. Ltd., Brown Meggs, Edward C. Khoury, William P. Rozette, Sir Joseph Lockwood, J. E. Read, J. G. Stanford and Glenn E. Wallichs.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit appears in the Appendix starting at page 1. The opinion of the District Court for the Central District of California appears in the Appendix starting at page 6.

JURISDICTIONAL STATEMENT

The judgment of the United States Court of Appeals for the Ninth Circuit was filed on June 11, 1980. A timely petition for rehearing en banc was denied on August 4, 1980. The petition for certiorari was filed within 90 days of the date of said denial. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTES, REGULATIONS AND RULES INVOLVED

This petition involves the construction of §10b of the Securities Exchange Act of 1934 [15 U.S.C. §78j(b)], Rule 10b-5 [17 C.F.R. §240,10b-5] promulgated thereunder, Rule 52(a) of the Federal Rules of Civil

Procedure and Rule 803(6) of the Federal Rules of Evidence. The full text of these statutes and regulations are set forth in the Appendix starting at page 14.

STATEMENT OF THE CASE

A. Factual Background

Petitioner and the class he represents were purchasers[2] of the common stock of Capitol Industries, Inc. between June 1, 1969 and December 31, 1971 (the "class period"). In December 1971, Petitioner filed suit in the United States District Court for the Central District of California alleging that the named defendants artificially inflated the purchase price of Capitol's common stock during the class period in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promul-

---

[2] These investors, including individuals, pension funds and other institutional and fiduciary investors, lost tens of millions of dollars as a direct result of defendants' conduct. Exhibit 4170.

gated thereunder. The named defendants are (1) Capitol Industries, Inc., then a public reporting company whose common stock was traded on the American Stock Exchange; (2) Capitol Records, Inc., the principal operating subsidiary of Capitol Industries, Inc. (3) E.M.I., Ltd., a publicly held British corporation which owned approximately 70% of Capitol's outstanding common stock during the class period; and (4) certain officers and directors of the above corporations. The district court's jurisdiction was properly invoked under the Securities Exchange Act of 1934 [15 U.S.C. §78a et seq.].

At trial, petitioner sought to prove that defendants knowingly or recklessly misrepresented and concealed significant operating problems experienced by Capitol and knowingly or recklessly engaged in practices and procedures contrary to generally accepted accounting principles and the requirements of full and fair disclosure.

Petitioner contended that defendants, by engaging in such conduct, materially misrepresented the earnings of Capitol and thereby artificially inflated the purchase price of Capitol's common stock.

Capitol first became a public reporting company in February 1968. At the close of its 1968 fiscal year (i.e., June 30, 1968), Capitol reported earnings of $.34 per share. Exhibit 1. At the close of fiscal 1969, Capitol's reported earnings jumped to $1.51 Id. By the end of fiscal 1970, its reported earnings had climbed even further to $1.91 per share. Exhibit 8.

During this period of dramatically increased reported growth (461% in the first two years Capitol was a public reporting company), Capitol's then president, Stanley Gortikov, made several speeches nationwide to securities analysts in which he contrasted the "stability" of Capitol to the risky, speculative, volatile and unpredictable

nature of the industry at large. Exhibit 4129 at 3-4. Mr. Gortikov attributed Capitol's operating successes and growth potential to its conservative financial reporting and accounting practices (Exhibit 4129 at 4-5), its professionally skilled managers (Exhibit 4130 at 8) and its continuing ability to develop new and successful artists (Exhibits 4130 at 4 and 8 and 4131 at 8). As a result of these statements and Capitol's reported growth, Capitol's common stock traded at a very high (i.e., 25-30) multiple of reported earnings during most of the class period. Compare Exhibit 1 and 8 with Exhibit 4117.[3]

While the investing public was being given the foregoing information, Capitol was in fact experiencing severe operating pro-

---

[3] Defendants stressed the need for Capitol to be able "to maintain [Capitol's] growth company image and its accompanying price/earnings ratio" .... so that Capitol would be able "to use additional shares favorably in an acquisition program." Exhibit 4155.

blems none of which were disclosed to the investing public. Defendants were able to conceal these undisclosed operating problems by the use of three interrelated and undisclosed devices. First, Capitol shipped to its customers and therefore recorded as sales quantities of records which far exceeded its customers' legitimate sales requirements. RT[4] 2586-91.[5] Second, defendants failed to establish the reserves necessary to account for the return and/or obsolescence of the excess merchandise shipped by Capitol to its customers. Finally, defendants improperly deferred the recognition of expenses, prematurely recog-

---

[4] "RT" refers to the Reporter's Transcript. "CT" refers to the Clerks' Record on appeal.

[5] Capitol was able to have its customers take shipment of this excess merchandise because its customers were able to make a substantial profit in doing so. Exhibit 936; RT 2465-66, 2591-92, 4237-38 and 2465-66. Moreover, any merchandise which its customers could not sell could be returned to Capitol for credit. RT 2334-40 and 4227-29.

nized income, and reversed funds from the inadequate reserves which did exist into reported operating income at strategic times without disclosure of their source.[6] In so doing, defendants violated generally accepted accounting principles and failed to comply with the requirements of full and fair disclosure.

Defendants' practices, none of which were publicly disclosed, contrasted sharply

---

[6] The District Court specifically found that defendants took substantial sums from various reserve accounts and reversed that money into income and reported it as operating income. CT 3718. These reserve reversals were not publicly disclosed to the investing public. The admitted effect of defendants' reserve reversals on fourth quarter profitability is shown by the chart below.

4th Qtr F/Y	$ From Resv. to Profit	Capitol's Rprt Pre-Tax Profit	% Pre-Tax Profits from Resv
1969	$2,430,943	$1,171,000	207%
1970	$2,836,000	$2,485,000	114%

The information with respect to Fiscal 1969 is taken from Exhibit 1601. The information with respect to Fiscal 1970 is derived from defendants' responses to discovery requests located in the record at CT 2097-98, CT 1839 and CT 1301.

with the "bullish" pictures painted by defendants in their public statements regarding the company's outlook and existing financial condition. These practices are summarized below in greater detail.

1. Accounting for Sales Returns

Generally accepted accounting principles require that a reserve be established at the time a product is sold if there exists a likelihood that the merchandise will be returned. RT 4787-93 and 5420-28; Exhibit 4088 at Tabs 2, 5 and 6. Despite the fact that defendants knew that 15% - 20% of Capitol's sales would be physically returned (Exhibits 4130 at 2 and 901 at 8), defendants refused to establish the required reserve during the class period (RT 6185-86 and 6197). Instead, Capitol deducted returns actually received during the fiscal year (including returns resulting from sales in prior reporting periods) from total album

///

sales in that year. CT 2963.[7] The result of this practice was to overstate Capitol's reported earnings in each reporting period in fiscal years 1969 and 1970 by at least 78% and by as much as 369%. Exhibit 4103A.

There is no factual dispute concerning defendants' knowledge that a reserve for returned products was required to match returns with the sales that generated them. RT 6184-85. In 1968, Capitol's chief financial officer, defendant Rozette, studied Capitol's method for accounting for album sales returns, and concluded that unless a reserve was established Capitol would not be able to match returns with the sales that

///

---

[7] Capitol thereby failed to match gross revenues and related expenses on a current basis. RT 4790-91 and 8449. Moreover, Capitol's practices resulted in it prematurely recognizing income prior to the substantial completion of the earnings process in violation of generally accepted accounting practices. RT 4792, 5144 and 8446-51.

generated them. Id.[8] Although Capitol's independent auditors agreed with these findings, Capitol's board of directors in 1968 rejected a proposal to establish the suggested reserve because the establishment of such a reserve would have required Capitol to incur a large ($9 million after-tax) charge to income and because Capitol had only recently become a public reporting company. RT 6185-86. In effect, the decision not to institute the required reserve was made so as not to adversely affect reported income and therefore the price of Capitol's stock. RT 5683-84. Capitol never established the required reserve during the class period even though standard industry practice during that time was to have such a

///

---

[8] With respect to Capitol's quarterly financial reports, Capitol's comptroller concluded that Capitol's then existing method of accounting for album sales returns would "seriously mislead an investor" and distort Capitol's reported income. RT 2779-83.

reserve (Exhibits 431 and 450-454).[9]

2. Capitol's Accounting for Product Obsolescence

Under generally accepted accounting principles, Capitol was required to carry its inventory at the lower of cost or market value. RT 5573; Exhibit 4088 - Tab 16 at 6015-17. Since Capitol's business policy was to scrap almost all inventory which it could not sell at regular prices, (i.e., obsolete inventory), Capitol was accordingly required to write its obsolete inventory down to its scrap value (approximately 3¢ per record) from the normal inventory carry-

---

[9] In recognition of the need to accurately match returns with the sales that generated them, Capitol did establish a "partial reserve" for internal purposes during Fiscal 1969-71, without disclosing the establishment of this "partial reserve" to the investing public. RT 6197-98. Moreover, at the close of each fiscal year, Capitol reversed, without public disclosure, the entirety of the "partial reserve" into fourth quarter earnings, thereby further misstating its fourth quarter earnings and disguising the seasonality of its business. RT 4886-88, 6214-15 and 7616.

ing cost (approximately 25¢ per record). RT 5568-69 and 5572-73.

Under these accounting principles, Capitol was therefore required to establish a reserve for inventory obsolescence equal to the difference between the manufacturing cost (25¢) and the scrap value (3¢) of its obsolete inventory. During the class period, Capitol's own internally generated reports concluded that at least 50% of Capitol's over-90-day-old inventory was obsolete.[10] Thus, a reserve for approximately 50% of Capitol's over-90-day inventory should have been established.

However, at no point during the class period did Capitol establish an adequate obsolescence reserve. Exhibits 1616A-C and 1615A-D. At the close of fiscal years 1969,

---

[10] As the district court observed, Capitol suffered a "tremendous problem" and a "constant problem" with respect to inventory obsolescence during the class period. RT 8165; CT 3719.

1970 and 1971, Capitol's reserve for obsolete inventory was understated (and reported income was correspondingly overstated) by approximately $2.116 million, $2.817 million and $1.795 million, respectively. Exhibits 1618A-C. Moreover, at no point during the class period did Capitol disclose to the investing public the existence or nature of its "tremendous" inventory obsolescence problem. In fact, Capitol's severe obsolescence problems were totally inconsistent with Capitol's affirmative representations to the investing public that it had realistically reserved for, among other things, product obsolescence. Exhibit 901 at 4-5.[11]

---

[11] Because a certain percentage of Capitol's "sales" would be returned but not thereafter sold, Capitol was also required to establish a reserve for the obsolescence of merchandise which had been "sold" but not yet returned (i.e., future returns). Exhibit 4116. No such reserve was established. RT 5548-49. By reason of this conduct, Capitol's reported income was overstated in fiscal years 1969, 1970 and 1971 by $1.783 million, $1.448 million and $1.786 million, respectively. Schedule A to Exhibits 1618A-C.

3. Capitol's Use of the Reserve for Cooperative Advertising Commitments

During the class period, Capitol also developed a cooperative advertising program which was designed to promote sales by giving Capitol's customers price discounts and funds for advertising. Exhibit 936. The amount committed to customers under this program in any given year was supposed to be recorded by Capitol's salesworkers contemporaneous with the commitment. CT 2201-02. In practice, however, the salespersons' records were incomplete, inaccurate, and consistently understated the actual amounts committed. CT 2202; RT 2006-07.

At the close of both fiscal 1969 and fiscal 1970, defendants knew and were warned by the sales department that its records which purported to reflect outstanding cooperative advertising commitments were inaccurate, unreliable and understated. See, e.g., RT 1953-56 and 4168-72. Nevertheless,

defendants established the level of the cooperative advertising reserve based upon these inaccurate and unreliable records (see, e.g., RT 3408-17) and reversed the remainder of the funds into reported operating income (see Note 5, supra). In addition, defendants, in fiscal 1970, established the reserve for cooperative advertising based upon an additional and totally unwarranted assumption that the sales force would drastically reduce the level of cooperative advertising in the last two months of the fiscal year despite knowledge that the proposed reduction was not communicated to the sales force until the last two weeks of the fiscal year. RT 1968-70 and 2394-95; Exhibit 913. Consequently, the cooperative advertising reserve was understated (and reported income was correspondingly overstated) at the close of fiscal 1969 and 1970 by approximately $660,000 and $1,000,000, respectively. Exhibit 1622A.

4. Capitol's Loans to Invictus

In May 1969, Capitol agreed to lend up to $2 million over a three and one-half year period to Invictus, a newly formed, independent production company. Exhibit I-1A. In return, Invictus granted Capitol the exclusive right to manufacture and distribute the music created by Invictus. Id.

The loans to Invictus were essentially advances against future royalties, and were the substantial equivalent of advances to an artist. In these circumstances, it was Capitol's standard practice to establish a reserve of 73% against advances to artists which were secured by the artists' royalties. RT 4857. However, with respect to Invictus' loans, Capitol did not establish such a reserve. RT 2204. Consequently, the Invictus loans, until June 1971, were carried on Capitol's books as assets at full value. Id.

The use of this extraordinary account-

ing procedure is even more remarkable in light of the unusual risk of the Invictus venture. Specifically, Invictus was a new venture with no operating capital apart from Capitol loans. Exhibit I-7; RT 2637. Invictus' potential for future success was dependent almost exclusively on the talent of three artists, two of whom were not even available to Invictus for the first two years of the three and one half year Capitol loan period. Exhibits I-7 and I-40. Invictus was not contractually obligated to meet any performance standard. Exhibit I-1A. Capitol had no control over the salaries paid or costs incurred by Invictus. Exhibit 157. Invictus was not obligated to provide Capitol with any cash flow projections. Exhibit 162 at 4. Finally, the three Invictus principals had no proven entrepreneurial skills. Exhibit 261 at 1-2.

Indeed, as time went by, the riskiness of the Invictus venture became even more

obvious. By the close of fiscal 1970, the first full year of Invictus' operation, only two successful artists had been developed, and Capitol concluded that there was no evidence that fiscal 1971 would be any better. Exhibits 151 and 177; RT 1611. Invictus was unable to meet its loan payments (Exhibit 220), Capitol was unable to get financial information from Invictus (Exhibits 154, 217 and 225), and defendants seriously questioned whether the Invictus principals were misappropriating the funds lent to them by Capitol (Exhibit 217). In fact, by this time Capitol was paying its loans back with funds supposedly advanced to Invictus. Exhibit 153.

By the beginning of calendar 1971, Capitol's management concluded that Invictus' sales would not allow repayment of the loans. Exhibits 151 and 177. Nevertheless, Capitol loaned Invictus another $500,000 (Exhibit I-40) with which it could

repay some of its current obligations to Capitol. It, however, refused to set up a reserve for these loans until the close of fiscal 1971. Exhibits I-52 and I-54.

By failing to establish the required reserve, Capitol represented to the investing public that it was more probable than not that the Invictus loans would be repaid in full. RT 4852-58. In so doing, Capitol overstated its assets during the class period, contrary to generally accepted accounting principles (RT 4854-55), Capitol's own internal guidelines (RT 4857) and, most important, its public representations (Exhibits 901 and 4129-31).

5. Holding Back Returns

At the end of fiscal 1970, defendants intentionally delayed the processing of returned albums and thereby deferred recognition of current expenses. RT 3810 and 2321-23. The purpose of this conduct was to enable Capitol to meet its predetermined

earnings goals for fiscal 1970 and maintain its growth company image. Exhibits 471 and 4155.[12] By holding back returned albums, Capitol overstated fiscal 1970 income by $1.6 million. RT 5252-61; Exhibit 4092.

6. Deferral of Convention Expenses

In order to meet its predetermined earnings goal in fiscal 1970, Capitol also intentionally deferred the recognition of convention expenses of approximately $155,000 incurred in 1970. CT 2204-05. This conduct was contrary to Capitol's prior accounting practice and contrary to the advice of Capitol's own accountants, who stated that these expenses should have been recognized when they were incurred, namely, the fourth quarter of 1970. Exhibit 425.

---

[12] Capitol had predetermined earnings goals for fiscal years 1970 through 1974. Exhibit 4155. This plan, which was authored by Capitol's President, Stanley Gortikov, was designed to enable Capitol to use additional Capitol stock favorably in an acquisition program. Id.

7. Standard Cost Adjustments

Prior to the first quarter of fiscal 1971, defendants wrote off all standard manufacturing cost adjustments during the course of a year on a strict first-in first-out (FIFO) basis. RT 3237 and 4969. Thus, when each unit of inventory was sold, cost of sales (an expense) was increased by the full carrying value of the unit of inventory, including all related standard manufacturing cost adjustments. Id.

In fiscal 1971, however, Capitol changed its accounting practice with respect to standard manufacturing costs without disclosure to the investing public. CT 3237; RT 5635-44. Instead of writing off adjustments when incurred, Capitol spread the total standard cost adjustment of $1.4 million incurred in 1971 equally over the four fiscal quarters and did not charge the expense against the sale of each unit of inventory on a FIFO basis. Exhibit 4083; RT 4968 and

5635. Capitol thereby deferred expensing the full inventory carrying value of each unit as sold. Id. As a result, Capitol reported inflated earnings for the first two quarters of fiscal 1971 by understating the actual expenses and reported losses incurred during the first two quarters of Fiscal 1971. RT 5635-44.

As noted, the above change in accounting practice was never disclosed. Compare Exhibit 9 at page 16 with Exhibit 16A at page 47. The requirement that financial statements be prepared on a consistent basis, unless disclosure to the contrary is made, was therefore not observed. RT 4796-97. As a result, no meaningful comparison between Capitol's financial statements in fiscal 1970 and 1971 was possible. Accordingly, one could not accurately assess Capitol's Fiscal 1971 operating performance.

///

///

8. Capitol's Failure to Disclose Its Dependence on the Beatles and Glen Campbell

Although Capitol represented itself to the public as a stable company in a volatile industry, it was largely dependent during the class period on two artists -- the Beatles and Glen Campbell. In fiscal 1969, for example, these two artists accounted for 57% of Capitol Records' net dollar sales and 67% of Capitol Records' pre-tax profits. Exhibit 4156 at Appendix B.

Contrary to their public statements, Capitol's management recognized that Capitol's extreme dependence on these two artists made it a risky company, and, as Gortikov himself recognized, this "high concentration [on two artists] is not consistent with long run stability and growth." Exhibit 4155 at 5. Indeed, when the public finally did learn of Capitol's dependence on the Beatles, at or about the time of their breakup, Capitol's stock price plunged by

50%. Exhibit 4117.

* * *

Plaintiff established at trial that the cumulative effect of the extraordinary practices discussed above was to dramatically overstate Capitol's per share reported earnings with what its actual earnings would have been had Capitol followed generally accepted accounting principles. The following chart demonstrates the extent of these overstatements.

	Fiscal 1969	Fiscal 1970	Fiscal 1971
Reported Earnings (Loss) per share	$1.51	$1.91	($2.55)
Actual Earnings (Loss) per share	($2.32)	($4.20)	($7.84)
Overstatement per share	$3.83	$6.11	$5.29

Additionally, plaintiff called a host of distinguished experts to support his contentions. Plaintiffs' experts included Charles Pardee, Associate Chief Accountant at the SEC, Division of Corporate Finance,

Messrs. Irwin Schumer and Eugene Mulrooney, both certified public accountants for more than twenty years, Dr. John Buckley, Associate Dean of UCLA's Graduate School of Management, and Dr. William Farrington, a Chartered Financial Analyst. Each of these experts opined, without exception, that defendants' conduct violated basic principles of full and fair disclosure and/or generally accepted accounting principles and therefore defendants materially misrepresented the operating results of Capitol during the class period and misled the investing public. RT 8321-24 (Pardee); RT 5215, 5218-24, 5234-37 and 5240 (Schumer); RT 8673-74 (Mulrooney); RT 8480-84 (Buckley); RT 9136-43 (Farrington).

Defendants, on the other hand, were able to produce only one expert who was willing to attempt to dispute the massive evidence of defendants' accounting improprieties. Defendants' accounting expert, al-

though testifying on certain limited issues, did not even attempt to rebut plaintiff's expert testimony on many of the accounting and disclosure principles discussed above.

B. The District Court's Decisions

The district court entered two rulings which are relevant to this writ. They are summarized below.

1. April 5, 1978 Memorandum of Decision

In its April 5, 1978 decision, the district court observed that defendants faced some very difficult problems during the class period, and that some of the actions taken by them "may have been unwise or imprudent or even inept." Appendix at 11. Nevertheless, the district court concluded that "in the absence of a sinister motive or culpable recklessness, neither of which is present here, these actions do not constitute a basis for relief in a 10b-5 lawsuit, in light of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)." Appendix at 11. Although

the district court did not define the term "culpable recklessness", its opinion makes clear that the term embraces the concept of a fraudulent purpose.[13]

2. The May 13, 1976 Ruling

On May 13, 1976 the district court granted defendants' motion to dismiss the

---

[13] In the beginning of its memorandum decision, the district court summarized its perception of the controlling law when it stated: "The basic trouble that I have with the plaintiff's case is that I am unable to conclude from the evidence that any such fraudulent purpose has been established. The closest that the plaintiff has come in his efforts to ascribe a culpable motive to the defendants' actions is in connection with the obvious attempt to achieve an earnings goal of $2.00 per share for fiscal year 1970. It is beyond doubt that Capitol's executives tried hard to reach the goal and that Mr. Khoury, in searching for ways to increase income toward the end of the year, examined and reexamined the reserves. In several much discussed instances, he concluded that substantial sums could be taken from these reserves and 'reversed into income.' Such actions were not taken furtively; they followed considerable widespread discussion, analysis and argument. The resulting decisions were based upon good faith judgments which, although they may have been influenced by the $2.00 goal, were not supplanted by that objective." Appendix at 7-8. [Emphasis added.]

allegations respecting Capitol's failure to disclose its dependence on the Beatles and Glen Campbell. RT 8223-25. In so ruling, the district court observed that Capitol's management considered its large dependence on these two artists to be a substantial operating problem but that defendants were attempting to solve this problem. RT 8224-26. Hence, the court found that defendants had not acted in "bad faith" and that, accordingly, no liability could attach to their conduct. Id. The district court also noted that disclosure of this substantial operating problem would have "tend[ed] to scare the shareholders and scare prospective shareholders" [i.e., the plaintiff class]. RT 8225. [Emphasis added.]

C. The Ninth Circuit's Decision

The United States Court of Appeals for the Ninth Circuit affirmed the district court's judgment on June 11, 1980. In so doing, the Ninth Circuit observed that "the

district court found that the conduct of appellees was based on good faith judgments, which, as a matter of hindsight, may have amounted to, at most negligence." Appendix at 2.[14] Quoting from this Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Ninth Circuit noted that "'[t]here is no indication that Congress intended anyone to be made liable ... unless he acted other than in good faith.' Id. at 206." Appendix at 2. Accordingly, the Ninth Circuit decreed it unnecessary to consider defendants' conduct in light of its prior recognition in Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978) that reckless conduct would give rise to liability. Id. at 2.

---

[14] The Ninth Circuit's conclusion in this regard is erroneous. Instead, the district court expressly stated that, "in the absence of a sinister motive or culpable recklessness", it felt it inappropriate for it to comment on the issues so exhaustively litigated. Appendix at 11-12.

In reading the Ninth Circuit's opinion, it is important to note that the district court expressly refused to consider whether defendants' conduct was negligent in light of its finding that defendants acted without a sinister motive or fraudulent purpose.[15] Thus, the Ninth Circuit's affirmance must be taken to mean that there can be no liability under Rule 10b-5 unless it is first shown that a defendant possesses a sinister motive or a fraudulent purpose.

REASONS FOR GRANTING THE WRIT

This writ should be granted because

---

[15] "However, in the absence of a sinister motive or culpable recklessness, neither of which was present here, these actions do not constitute a basis for relief in a 10b-5 law suit, in light of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Under these circumstances, the issues that were litigated so exhaustively at the trial become reduced to questions of policy, or wisdom, or 'GAAP' or even negligence, and it is unnecessary and inappropriate for this court to express its views concerning them." Appendix at 11-12.

there is serious conflict and, indeed, confusion among the circuits respecting an issue of major public importance -- the interpretation of this Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). This conflict centers on (1) whether reckless conduct gives rise to liability under Section 10(b) (a question specifically reserved by this Court in Hochfelder) and, if it does, whether "good faith" is a defense to recklessness, and (2) whether a "good faith" defense is limited to proof of defendants' "good faith" in connection with the alleged misrepresentations, omissions or the disclosure requirements of a public reporting company, as contrasted with defendants' "good faith" in managing the company's business.

Additionally, the writ should be granted to resolve the conflicts which presently exist among the circuits as to whether the "clearly erroneous" standard of

review applies to the ultimate legal determination of recklessness, and the proper interpretation of Federal Rule of Evidence 803(6).

A. Does Reckless Conduct Give Rise to Section 10(b) Liability, and, If It Does, Is "Good Faith" A Defense

In Ernst & Ernst v. Hochfelder, supra, this Court held that a private action under Section 10(b) and its amplifying regulation, Rule 10b-5, could not be stated on the basis of an allegation of negligence. Instead, it was ruled that a private Rule 10b-5 plaintiff must allege and prove scienter, defined as a "mental state embracing intent to deceive, manipulate or defraud." Id. at 193. This conclusion derived from the legislative history of Section 10(b), which this Court read to mean that Congress did not intend anyone to be held liable unless they acted other than in "good faith." Id. at 206. Accordingly, it was stated that those who act knowingly and intentionally are subject

to liability under Section 10(b) and Rule 10b-5. Id. at 197.

The question of whether reckless conduct would, in some circumstances, also give rise to Section 10(b) liability, however, was specifically reserved in Hochfelder.[16] In so doing, this Court, by implication, also reserved the question of whether "good faith" is inconsistent with, and hence, not a defense to, reckless conduct.

Since Hochfelder, the circuits have grappled with the implications of the reserved question. Although the circuits have uniformly held that reckless conduct is actionable under Section 10(b) and Rule 10b-5,[17] there has been no uniformity on the

---

[16] "We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5." 425 U.S. at 193, n.12. This question was also reserved in the Court's recent decision in Aaron v. SEC, 100 S.Ct. 1945, 1950 at n.5 (1980).

[17] Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978); Coleco
(ftnt|cont)

question of whether a defendants' professions of "good faith" constitute a defense to liability for reckless conduct.

In the instant case, both the district court and the Ninth Circuit held that defendants could not be liable under Section 10(b) and Rule 10b-5 because plaintiff failed to overcome a threshold burden of proving that defendants acted with a "fraudulent purpose," or a "sinister motive" or other than in "good faith." In the absence of such a showing, the Ninth Circuit concluded that it was unnecessary to determine whether plaintiff had proved recklessness.

In its opinion in this case, the Ninth Circuit expressly endorsed the concept of "culpable recklessness" first enunciated by

Industries, Inc. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977); First Virginia Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977); Marsbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023-24 (6th Cir. 1979); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1039-40 (7th Cir. 1977); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978).

the district court. [Emphasis added.] Although neither the district court nor the Ninth Circuit elaborated on the parameters of "culpable recklessness", it is reasonably clear from the holdings below that it encompasses two elements. First, the defendants' state of mind must be subjectively analyzed to determine if his motive in acting was sinister or fraudulent in nature. If not, no further analysis is required for no liability can attach. If, however, it is determined that defendants' state of mind is sinister or fraudulent, then it must be determined whether the conduct complained of was reckless.

The Ninth Circuit's position on this issue directly conflicts with the Second Circuit's decision in Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38 (2d Cir. 1978). In Rolf, it was held that reckless conduct is actionable under Section 10(b) and Rule 10b-5 but that defendants' "good

faith" is not a defense to recklessness. In reaching this result, the Second Circuit concluded that reckless behavior, determined by objective standards, is inconsistent with good faith.[18] Thus, the preclusion of a "good faith" defense to reckless conduct was held to be consistent with Hochfelder. The Second Circuit in Rolf noted that:

> "A major purpose of the Hochfelder decision was to foreclose 'liability for wholly faultless conduct where such conduct results in harm to investors.' 425 U.S. at 198, 96 S.Ct. 15 1383. Adoption of a recklessness standard in this case does not result in liability for 'wholly faultless conduct' and thereby does not impede an important policy of §10(b) and Rule 10b-15 as recognized in Hochfelder. Hochfelder

---

[18] The Second Circuit's decision in Rolf, of course, is consistent with the traditional, common law view of recklessness whereby the actor's conduct is viewed from an objective standpoint. Recklessness has traditionally been defined as highly unreasonable conduct accompanied by a conscious indifference to the consequences. Since this mental state "is almost never admitted, and can be proved only by the conduct and the circumstances, an objective standard must of necessity in practice be applied." Prosser, Law of Torts, §34 at 185 (4th Ed. 1971). See also, Restatement (Second) of Torts, §500 (1965).

> itself found that '[t]here is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catchall provision of § 10(b) should be interpreted no more broadly.' 425 U.S. at 206, 96 S.Ct.at 1387. Reckless behavior hardly constitutes good faith. Since good faith does not constitute a defense to reckless or intentional conduct, a recklessness standard is fully consistent with Hochfelder on its own terms." 570 F.2d at 46, n.15.

Clearly, then, the Second and Ninth Circuits are in direct conflict on the question of whether "good faith" is a defense to reckless conduct.

In addition, the Seventh Circuit has taken a position which is seemingly somewhere between that of the Ninth and Second Circuits and which is inconsistent on its face. In Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir.), cert. denied, 434 U.S. 875 (1977), it was held that liability for reckless conduct will lie where "the danger of misleading buyers [is] actually known or so obvious that any reasonable man would be legally bound as

knowing, and the omission must derive from something more egregious than even 'white heart/empty head' good faith." 553 F.2d at 1045. [footnotes omitted]. Although the second prong of this test implies that some type of "good faith" defense may be available to one accused of recklessness, the opinion specifically states elsewhere that good faith is not a defense to reckless conduct. 553 F.2d at 1044, n.17. While it is certainly unclear from these conflicting statements whether the Seventh Circuit recognizes any type of "good faith" as a defense, it is clear from the Sundstrand opinion that in no event is proof of defendants' lack of "good faith" a threshold burden which a plaintiff must establish before examining defendants' conduct. Here, of course, the Ninth Circuit has specifically adopted the position that a sinister or culpable state of mind must be proved before defendants' conduct is re-

viewed.[19] In this respect at least, the Ninth Circuit decision in this case is directly at odds with the position of the Seventh, as well as the Second, Circuit.

What the opinions in Rolf, Sundstrand and the instant case do show is that there is significant conflict and confusion on the issue of "good faith" as it relates to reckless conduct and that this conflict and confusion stem directly from the question this Court left reserved in Hochfelder. In essence, the Ninth Circuit has held in the instant case that Hochfelder must be read to mean that proof of specific intent to defraud is essential to establish liability under Section 10(b), irrespective of whether the conduct is characterized as intentional,

---

[19] Under this legal standard, neither the district court nor the court of appeals reviewed or analyzed defendants' conduct to determine if it constituted recklessness because they initially found that defendants' did not have a "fraudulent purpose" or "sinister motive".

knowing or reckless.[20] Under this reasoning, recklessness necessarily becomes the functional equivalent of intentional conduct, which is just another way of saying that recklessness, viewed traditionally from

---

[20] If this accurately reflects the Ninth Circuit's view of Hochfelder, which we submit it does, it also conflicts in principle with the position recently espoused by the Court of Appeals for the District of Columbia Circuit. In SEC v. Falstaff Brewing Corp., [Current Volume] Fed.Sec.L.Rep. (CCH), ¶97,505 (D.C. Cir. 1980), the court formulated a definition of knowing conduct. In that regard, defendant claimed that "scienter requires an inquiry 'into the defendant's state of mind - his subjective beliefs to the legality of his action...'" Id. at 97,641. The court strongly disagreed, stating:

> "Knowledge means awareness of the underlying facts, not the labels that the law places on those facts. Except in very rare instances, no area of the law - not even the criminal law - demands that a defendant have thought his actions were illegal. A knowledge of what one is doing and the consequences of these actions suffices. We therefore hold that because Kalmanovitz knew the nature and consequences of his action, he acted with scienter." Id. (footnotes omitted).

In a footnote, the court also went on to note that the same analysis applied to both knowing and reckless behavior. Id. at 97,641-42, n.27.

an objective standpoint, is not actionable under Section 10(b).

We respectfully submit that the time is here for this Court to finally answer the important question it left reserved some four years ago, and to end the conflict and confusion that presently exists in the circuits respecting this issue. This case presents a perfect opportunity to do so.[21] Here, the claim is that a public reporting company misrepresented its earnings and operating condition by engaging in a plethora of practices in violation of generally accepted accounting principles and the requirements of full and fair disclosure. The collective result of this conduct is most graphically demonstrated by the chart below:

---

[21] This is especially so in light of the fact that this case has been fully tried on the merits and does not come to this Court after summary disposition. Moreover, unlike Hochfelder, this case involves the liability of a public reporting company which was subject to the reporting requirements of the 1934 Securities Exchange Act.

	Fiscal 1969	Fiscal 1970	Fiscal 1971
Reported Earnings (Loss) per share	$1.51	$1.91	($2.55)
Actual Earnings (Loss) per share	($2.32)	($4.20)	($7.84)
Overstatement per share	$3.83	$6.11	$5.29

During this period of overstated earnings, Petitioner and the class purchased Capitol's common stock at artificially inflated prices. The only viable remedy available to the class members under the federal securities laws in this case is under Section 10(b). Consequently, there can be no basis for concern that an expansion of rights under Section 10(b) may serve to nullify other sections of the federal securities laws with stricter procedural limitations. See Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 208-211.

Moreover, the need for an objective recklessness standard for Section 10(b) liability in this type of case becomes even

more apparent because of the absence of any material face-to-face dealings between the class and the defendants. If, as the Ninth Circuit has ruled here, Rule 10b-5 liability can only be imposed on a public reporting company if it is proved that it had a specific intent to deceive, then open market purchasers with whom the company has had no direct dealings will effectively be denied redress under the federal securities laws. Stated simply, the burden of proving the element of motive required by the Ninth Circuit in this case will be virtually insuperable. This practical problem of proof was correctly observed by the Second Circuit when it stated in Rolf v. Blyth, Eastman Dillon & Co., supra, 570 F.2d at 47:

> A final basis for applying a recklessness standard in certain instances rests perhaps on the practical problem of proof in private enforcement under the securities laws. Proof of a defendant's knowledge or intent will often be inferential, see Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy in Pari Delicto, Indemnification, and

Contribution, 120 U.Pa.L.Rev. 597, 635(1972), and cases thus of necessity are cast in terms of recklessness. To require in all types of 10b-5 cases that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under §10(b).

For the foregoing reasons, we respectfully submit that a writ of certiorari should be granted to resolve this important issue.

B. The Decision Below Conflicts With The Decisions of Other Courts of Appeal as to the Definition of "Good Faith" in the Context of Rule 10b-5 Actions

In the decision below, both the district court and the Ninth Circuit held that defendant Capitol was not liable for alleged violations of Rule 10b-5 because its employees acted in good faith. Appendix at 2, 8 and 11. However, a close reading of the district court's opinion reveals that the "good faith" which was found by that court related solely to defendants' management of Capitol and not to the misrepresentations or omissions at issue in the lawsuit. Appendix

at 8 and 11. Hence, in concluding that there was no liability, the district court adopted - and the Ninth Circuit affirmed - the principle that good faith solely in the internal management of a corporation is a defense to liability under Rule 10b-5.

This position is contrary to that of the Second, Third, Fifth and Seventh Circuits. In the cases in the above circuits which address this issue, there is not even a suggestion that "good faith" in the internal management of the corporation is sufficient to exculpate a defendant who is alleged to have violated Section 10(b).

In short, the circuits (with the exception of the Ninth Circuit in this case) have uniformly framed the standard of examinable conduct under Rule 10b-5 to be within the context of disclosures or omissions of material information - not the internal manage-

///

///

ment of the corporation.[22] In the words of the Second Circuit,

> "In determining what constitutes 'willful or reckless disregard for the truth' the inquiry normally will be to determine whether the defendants knew the material facts mistated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort. [citation] Lanza v. Drexel & Co., 479 F.2d 1277, 1306 n.98 (2d Cir. 1973). [Emphasis added.]

Since the conduct which results in liability under Rule 10b-5 occurs within the context of disclosing or withholding material information, the "good faith" which is alleged to preclude it must occur within the same context. Accordingly, there must be a finding that the disclosures or omissions

---

[22] Second Circuit: Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir.1973); Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 46 (2d Cir. 1978); Third Circuit: McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Fifth Circuit: First Virginia Bankshares v. Benson, 559 F.2d 1307, 1314-1315 (5th Cir. 1977); Seventh Circuit: Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977).

were in good faith.

Here, the court made no such finding. The closest it came was to find that defendants' attempts to resolve Capitol's severe operating problems - as contrasted with defendants' failure to disclose them - were in good faith. Appendix at 8-11.[23] For example, although the district court found that the reversing of reserves into income

---

[23] The district court did state that defendants "sought to ... make such disclosures in their releases to stockholders and the public as were indicated under the circumstances." Appendix at 11. This statement, however, does not constitute a finding of good faith disclosures to the investing public. There is no finding that defendants in good faith attempted to comply with the requirements of full and fair disclosure. Further, the district court did not articulate what, if any, legal standard it was applying.

Moreover, this statement must be read in context with the district court's earlier statement that defendants were not required to make disclosures which would have tended to "scare prospective shareholders." RT 8225. At most, the district court's statement means simply that defendants did what they thought was in the best interest of the company and present shareholders and not prospective investors.

was in good faith, the court did not find that the failure to disclose these reversals was similarly in good faith. See, Appendix at 8.[24] In so doing, the district court missed the crucial issue, namely, whether the failure to disclose the reversals of reserves into income constituted a violation of Rule 10b-5.

In allowing a defense to liability under Rule 10b-5 by virtue of professed "good faith" in the internal management of the defendant company, the district court and the Ninth Circuit created a novel defense which is both unwise and dangerous. Clearly, conduct which relates solely to the

---

[24] The failure of the district court to make such a finding is significant (1) in light of the fact that the Second Circuit in Kaiser-Frazer Corp. v. Otis Co., 195 F.2d 838 at 843 (2d Cir. 1952) specifically held that a purchaser is entitled to know that profits did not come from current operations and (2) in light of the fact that the reserve reversals in this case comprised 207% and 114% of Capitol Industries' pretax profits for the fourth quarters of fiscal 1969 and fiscal 1970. See, Note 5, supra.

internal operation of the defendant company has neither a logical relationship nor a legal significance to a determination of liability under Rule 10b-5.[25] Indeed, further judicial recognition of such a defense will establish an insuperable burden of proof in actions brought under Rule 10b-5, thereby eliminating the viability of this important statute.

The writ should be granted on this issue for several additional public policy reasons. The legislative history of the 1934 Securities Exchange Act [15 U.S.C. §78 et. seq.] plainly indicates that Congress intended accurate and full corporate reporting to be the keystone to the functioning of

---

[25] Similarly, this Court has repeatedly recognized the clear distinction between Rule 10b-5 actions (which must be based on misrepresentations or omissions) and actions involving claims for breach of fiduciary duty or mismanagement. Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977); Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

the securities markets. H.R. Rep. No. 1383 73d Cong., 2d Sess. 11 (1934). Dr. William B. Farrington, a Ph.D and a Chartered Financial Analyst, expressed business' deep concern about the public affect of this case. In his testimony, Dr. Farrington stated that, unless financial analysts are given honest data, their analyses would be useless (RT 9142) and that misleading information would make it virtually impossible for any investor to make a rational investment decision (id.)

If the investing community is precluded from obtaining honest and full informtion from public reporting companies because the officers and directors of such companies acted in good faith in managing the company, the consequence to our national economy will be devasting. Dr. Farrington testified, in this regard, that the long term affects of defendants' conduct on America's capitalistic system were alarming. For example, he

stated that defendants' practices:

> "would impair the ability of our capitalist economy for industry to be able to tap the financial markets and be able to obtain either underwritings, equity, debt or bank loans, because the underwriters and banks would not be able to know what they were really dealing with."
> Moreover, I think that investors would tend to lose faith in their financial institutions and might put their savings into a mattress instead of into investments and this has happened historically. The last time it happened here was during the bank holiday that started on March 7, 1933, so dramatic that I still remember it was a Saturday." RT 9142-43.

Professor John Buckley, Associate Dean at UCLA's Graduate School of Management echoed Dr. Farrington's concern that sanctioning defendants' practices would erode confidence in the securities markets. RT 8826.

There is no question that the viability of the economy of the United States is dependent upon the public's confidence in our financial markets and our business institutions in general. The Court's decision in Ernst & Ernst v. Hochfelder, however, has spawned tremendous uncertainty, direct con-

flicts and confusion among the various circuits regarding the applicable law which directly undercuts the needed public confidence. This case presents the Court with a clear opportunity to set the disclosure standards for a public reporting company and to resolve these conflicts, dispel the confusion that currently exists and assure investors that the law does and will in the future require that they be given full and honest information.

The importance of these issues, coupled with the conflicts discussed above, justify the grant of certiorari to review the judgment below.

C. The Decision Below Conflicts With The Decisions of Other Courts of Appeals as to the Applicability of the "Clearly Erroneous" Standard of Federal Rule of Civil Procedure 52(a)

Federal Rule of Civil Procedure 52(a) provides that findings of fact shall not be set aside by an appellate court unless the findings are "clearly erroneous." Conclu-

sions of law, however, are not subject to the "clearly erroneous" standard and are freely reviewable on appeal. United States v. Parke Davis & Co., 362 U.S. 29, 43-44 (1960).

A critical issue in this case was whether Capitol's alleged misconduct constituted actionable recklessness within the meaning of Rule 10b-5. With little elaboration,[26] the District Court found that it did not. Appendix at 7-12. In reviewing the district court's legal holding that plaintiff had failed to show actionable recklessness, the Ninth Circuit applied the "clearly erroneous" standard of review. Appendix at 3-4.

In so ruling, the Ninth Circuit adopted

---

[26] This Court has noted that without detailed findings of fact and conclusions of law, which was not afforded Petitioner, meaningful appellate review cannot be secured. Cf. Carter v. Stanton, 405 U.S. 669, 671-72 (1972). See also, Hanson v. Aetna Life & Cas., 625 F.2d 573, 575 (5th Cir. 1980).

a position which is contrary in principle to that of the Second, Fifth and Sixth Circuits, which hold that a trial judge's conclusion as to the legal significance of evidentiary facts - as opposed to the subsidiary evidentiary facts themselves - is freely reviewable on appeal.[27] The Sixth Circuit, in reviewing a finding that a term was not a trademark, set forth the applicable rule: "This conclusion is either a mixed finding of fact and conclusion of law, or it is a finding of an ultimate fact in the making of which involved legal principles. In either event, it is subject to

---

[27] Second Circuit: First National Bank of Cincinnati v. Pepper, 547 F.2d 708, 710-711 (2d Cir. 1976); In re Hygrade Envelope Corp., 366 F.2d 584, 587-589 (2d Cir. 1966); Fifth Circuit: Ayers v. Western Line Consolidated School District, 555 F.2d 1309, 1315 (5th Cir. 1977); Galena Oaks Corp. v. Scofield, 218 F.2d 217, 219-220 (5th Cir. 1954); Sixth Circuit: Old Dutch Foods, Inc. v. DanDee Pretzel & Potato Chip Co., 477 F.2d 150, 153 (6th Cir. 1973); United States v. Weingarden, 473 F.2d 454, 460-461 (6th Cir. 1973).

appellate review and the clearly erroneous rule has no application. [citations.]" Old Dutch Foods, Inc. v. DanDee Pretzel & Potato Chip Co., 477 F.2d 150, 154 (6th Cir. 1973).[28]

By recognizing the critical distinction between a finding of fact and the formulation and application of a legal standard, this approach insures the careful articulation of findings and conclusions by the trial court, which in turn facilitates effective review by a court of appeals. Moreover, the free review of the formulation and application of a legal standard promotes the administration of justice by allowing the appellate court appropriate supervision over

---

[28] See also In re Hygrade Envelope Corp., 366 F.2d 584, 588 (2d Cir. 1966) ("... when the issue is [the trial court's] application of a legal standard to facts undisputed or reasonably found, reversal is not limited to results that are 'clearly erroneous'; it is enough that the appellate court should be convinced ... that the result does not jibe with the applicable rule of law.")

the legal reasoning of the trial court. As observed by Judge Friendly, "Save when the trial judge has gone to unusual lengths in his opinion, the only way in which an appellate court can determine whether he correctly apprehended ... the general standard is by reviewing his result, and, if that review is to be effective, it must be unimpeded." Mamiye Bros. v. Barber Steamship Lines, Inc., 360 F.2d 774, 777 (2d Cir. 1966).

Finally, application of this standard of review promotes uniformity and consistency in the application of the law:

> It would be shocking if contrary decisions of two district judges in this circuit on exactly the same facts had to be left standing, although there would be no similar shock if such a divergency should happen as a result of the deliberation of two different juries. Compare United States v. Maybury, 274 F.2d 899 (2d Cir. 1960). Yet uniformity within a circuit or among circuits can be achieved only if appellate review of the application of a legal standard is free of the shackles of the "unless clearly

///

///

erroneous" rule. Id. [Footnote omitted.][29]

Although certain panels of the Ninth Circuit have endorsed this position,[30] the Ninth Circuit in this case applied the clearly erroneous standard to the District

---

[29] The uniformity of application is particularly important where, as here, the statute and regulation in question directly affect the functioning of the nation's capital and debt markets. Unless one uniform legal standard is adopted by this Court, the efficiency of and the confidence in financial markets will be seriously undermined. American business, in turn, will find it increasingly difficult to raise the needed capital to revitalize this nation's economy.

[30] See, e.g., Fleischman Distilling Corp.v. Maier Brewing Corp., 314 F.2d 149, 151-152 (1963) where the Ninth Circuit held, in a trademark infringement case, that whether a brand name "is likely to cause confusion or mistake or to deceive purchasers as to the source..." was a question of law fully reviewable by the Ninth Circuit. [Emphasis added.] In this regard, the Ninth Circuit noted that:

> "'When a finding is essentially one dealing with the effect of certain transactions or events, rather than a finding which resolves disputed facts, an appellate court is not bound by [the clearly erroneous rule], but is free to draw its own conclusions.' Stevenot v. Norberg, 9 Cir. 210 F.2d 615, 619. [Emphasis added.]

Court's conclusion regarding "culpable recklessness." This legal conclusion therefore did not receive the free and complete review which it would have received in the Second, Fifth or Sixth Circuits. This was especially crucial in this case since the issue of recklessness was admittedly a "close question". Appendix at 3.

In view of the recurring nature of this issue - namely, the appropriate standard of review of mixed questions of fact and law - these direct conflicts justify the grant of the writ to review the judgment below.[31]

D. The Decision Below Conflicts With the Decisions of the Second Circuit as to the Proper Interpretation of Federal Rule of Evidence 803(6)

Exhibit 416A is a memorandum prepared by a partner at Coopers & Lybrand

---

[31] This is especially so where the Ninth Circuit has held that whether conduct deceives purchasers of goods is a question of law. Note 30, supra. The same standard of review should apply in this case where Petitioner and the class have allegedly been deceived in the purchase of securities.

("Coopers") regarding Coopers' Fiscal 1972 audit of Capitol.[32] This memorandum, which was prepared within a month of the close of the Fiscal 1972 audit and which was sent to four senior partners at Coopers, severely criticized Capitol's accounting and financial reporting practices and was therefore highly probative on the issue of defendants' scienter. Although plaintiff repeatedly moved Exhibit 416A into evidence on the ground that it was a record of a regularly conducted activity under Rule 803(6) of the Federal Rules of Evidence, the district court below refused to allow the exhibit into evidence, and the Ninth Circuit affirmed.

In so doing, the district court - and the Ninth Circuit - interpreted 803(6) very restrictively. Both courts apparently assumed that proof that a document was pre-

---

[32] A true copy of Exhibit 416A is included in the Appendix starting at page 18.

pared in "the regular practice of that business activity" required a showing that the document is of a repetitive or routine nature.

This restrictive interpretation is contrary in principle to that of the Second Circuit, which has continually held that the "business records" exception contained in Rule 803(6) is to be liberally construed. The Second Circuit's approach is best summarized as follows: "we do not think [28 U.S.C. §1732, the predecessor to Rule 803(6)] should be interpreted in a dryly technical way, contrary to ordinary habits and customs, to reduce sharply its obvious usefulness. Korte v. New York, N.H. & H.R. Co., 191 F.2d 86, 90-91 (2d Cir. 1951).

Indeed, the principle purpose of Rule 803(6) was to shift away from a "dryly technical" approach and to emphasize instead the theoretical underpinnings of the hearsay exception. Courts thus stress the usual

reliability and trustworthiness engendered "by the actual experience of business in relying upon, or by a duty to make an accurate record as a part of a continuing job or occupation" in determining admissibility. Notes of Advisory Committee on Proposed Rules, 28 U.S.C.A. 803(6) at 587, Pub. l. 93-595.

In endorsing the district court's rejection of Exhibit 416A on the ground that it was not repetitive or routine in nature, the Ninth Circuit defeated the purpose of Rule 803(6). The Ninth Circuit completely overlooked the fact that the Exhibit was an important business communication from one partner to four more senior partners and that it was written to guide them in their dealings with Capitol's management during the course of the continuing business relationship. The Ninth Circuit also overlooked the fact that there was no motive to falsify or misrepresent. In short, the Ninth Cir-

cuit unduly restricted the scope of Rule 803(6) by establishing the artificial requirement that a document be of repetitive or routine nature, notwithstanding the fact that it might be otherwise reliable and trustworthy in light of the actual experience of business. See, Rule 803(24) of the Federal Rules of Evidence.

The conflict between the Ninth Circuit's approach, on the one hand, and that of the Second Circuit, on the other, is significant. It is ripe for review. It affects the conduct of virtually all litigation involving a business in federal courts. As such, this important issue justifies the grant of the writ.

///

///

///

///

///

///

CONCLUSION

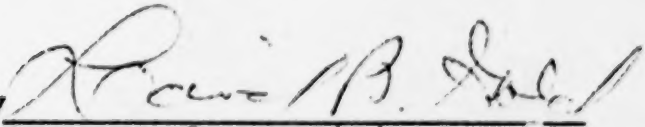
For the foregoing reasons, the Court should grant the writ as requested.

Dated: October 31, 1980

DAVID B. GOLD
A PROFESSIONAL LAW CORPORATION

AND

EDITH S. NEWMAN, Esq.

By 
Attorneys for Petitioner and
the Plaintiff Class

APPENDIX

TABLE OF CONTENTS

	Description	Page No.
1.	Memorandum of the United States Court of Appeals for the Ninth Circuit, dated June 11, 1980	1
2.	Memorandum of Decision of the United States District Court for the Central District of California, dated April 5, 1978	6
3.	Text of Section 10b	14
4.	Text of Rule 10b-5	15
5.	Text of Rule 803(6), Federal Rules of Evidence	16
6.	Text of Rule 52(a), Federal Rules of Civil Procedure	17
7.	Private Memorandum from N.A. Erickson to J.D. McMenamin re Capitol Industries, Inc., dated September 2, 1972	18

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ROCCO M. CATENA, et al.,	)	
	)	
Plaintiff-Appellant,	)	No. 78-2255
	)	
v.	)	DC No. CV
	)	71-2928
CAPITOL INDUSTRIES, INC.,	)	
	)	MEMORANDUM
Defendants-Appellees.	)	
	)	

Appeal from the
United States District Court for the
Central District of California

Before: CHOY, HUG, Circuit Judges, and
BILBY,* District Judge

Catena appeals from the judgment against him and the class he represents in this action under the Securities Exchange Act of 1934, §10(b), 15 U.S.C. §78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5. We affirm.

Catena contends the district court improperly required actual intent to establish a violation of §10(b) and Rule 10b-5,

* The Honorable Richard M. Bilby, United States District Judge for the District of Arizona, sitting by designation.

and ignored our decision in Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978), where we held that knowing or reckless conduct satisfies the scienter requirement. We disagree. The district court found that the conduct of appellees was based on good faith judgments which, as a matter of hindsight, may have amounted to, at most, negligence. The Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), eliminated negligence as a basis of liability under §10(b) and Rule 10b-5, saying, "There is no indication that Congress intended anyone to be made liable ... unless he acted other than in good faith." Id. at 206. Thus, the district court's findings of good faith and (at most) negligence precluded liability; it was unnecessary for the court to consider the Nelson v. Serwold recklessness standard.

Catena challenges as clearly erroneous the court's finding that there was no more

than negligence. The issues of whether Capitol's accounting procedures were proper and what disclosures were required regarding these procedures were hotly contested at trial. Each side marshalled experts who opined in support of the conflicting positions. Catena's side had more experts, it is true, but the trial court did not clearly err by refusing to endorse their opinions.

According to the district court, Catena's best argument for liability regarded Capitol's efforts to achieve its earnings goal of $2.00 per share for fiscal year 1970. After its careful consideration of the voluminous evidence, however, the court found no "culpable recklessness" in Capitol's actions. Although this clearly was a close question, after reviewing the entire evidence, we are not "left with a definite and firm conviction that a mistake has been made." United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948).

Similarly, the district court's findings on the remaining allegations of accounting and disclosure improprieties also are not clearly erroneous. Fed. R. Civ. P. 52(a).

The district court properly dismissed Catena's claim relating to Capitol's failure to disclose its dependence on the Beatles and Glen Campbell. Capitol did in fact disclose that the Beatles and Glen Campbell were its record sales leaders. The district court's implicit finding that Capitol was not additionally required to disclose the specific percentages of its record sales by these artists is not clearly erroneous.

Finally, the district court's rulings that a newspaper interview and an accountant's extraordinary memorandum were inadmissible hearsay were not reversible error.

Because we affirm the district court's finding of no liability, we do not reach the question whether it was error to require the class members to file proof of their claims

prior to the determination of Capitol's liability. Nor do we reach the question whether the court misapplied the "controlling person" doctrine in dismissing Catena's claims against certain defendants; because Capitol committed no securities law violation, it is irrelevant whether these defendants were controlling persons.

AFFIRMED

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

ROCCO M. CATENA, etc., Plaintiff, v. CAPITOL INDUSTRIES, INC., et al., Defendants.	)	CIVIL NO. 71-2928-WPG MEMORANDUM OF DECISION

Following receipt of the plaintiff's Post Trial Reply Brief, on January 25, 1978, I have read that two-volume document, the defendants' four-volume Post Trial Brief, and the plaintiff's two-volume Opening Trial Brief (Corrected), and have restudied the notes that I took in the course of the trial. Although, as the plaintiff pointed out in his Reply Brief, I did express an intention to have oral argument before making a decision, I find that the matter has been so thoroughly briefed that oral argument is unnecessary. Accordingly, this

Memorandum will announce the decision of the court and will contain such findings of fact as I believe to be indicated.

For reasons hereinafter set forth, judgment will be for the defendants on the complaint and plaintiff Catena and the members of the plaintiff class will take nothing. Defendant Capitol Industries-EMI will take nothing on its counterclaim against plaintiff Catena.

The plaintiff's case is based primarily upon the contention that the defendants engaged "in a common course of fraudulent conduct designed for one central purpose, i.e., to misrepresent the operating results of Capitol so as to artificially inflate the market price of Capitol common stock." (Reply Brief, page 327). The basic trouble that I have with the plaintiff's case is that I am unable to conclude from the evidence that any such fraudulent purpose has been established. The closest that the

plaintiff has come in his efforts to ascribe a culpable motive to the defendants' actions is in connection with the obvious attempt to achieve an earnings goal of $2.00 per share for fiscal year 1970. It is beyond doubt that Capitol's executives tried hard to reach that goal and that Mr. Khoury, in searching for ways to increase income toward the end of the year, examined and reexamined the reserves. In several much discussed instances, he concluded that substantial sums could be taken from these reserves and "reversed into income." Such actions were not taken furtively; they followed considerable widespread discussion, analysis and argument. The resulting decisions were based upon good faith judgments which, although they may have been influenced by the $2.00 goal, were not supplanted by that objective. There is no credible indication in the record that any of the defendants were determined that the company should announce

earnings of $2.00 per share at all costs. On the contrary, although company executives commenced their post audit discussions with Haskins & Sells at the close of fiscal year 1970 in the belief that they could report earnings approaching $2.02 per share, such discussions brought about the conclusion that the need to increase certain reserves would result in a reduction of $1.94. This figure was presented to the board of directors, which decided that the reported figure should be further reduced to $1.91 in order that the reserve for bad debts might be increased. (Exhibit BD-29; Tr. pages 6172-75).

In the course of the long trial, there was presented to the court a thorough and critical analysis of many of the policies and practices of Capitol's management. Such examination included: sales policies and the adequacy of controls with respect to cooperative advertising, allowance of returns, and

so-called "loading"; the appropriateness of using a "current" method of accounting for sales returns and the maintenance of an "interim" reserve until the arrival of a propitious time to convert to a permanent reserve; the sufficiency of other reserves and the propriety of making certain withdrawals from them and thereby enhancing profit; the handling of the constant problem of obsolescence; the accounting treatment of the Invictus loan; the "carry over" of some of the sales convention expenses; the handling of standard cost adjustment variance; and the validity and sufficiency of published financial statements and of Mr. Gortikov's speeches.

I have reviewed the testimony and studied the detailed contentions of the parties with respect to each of the above listed matters. Taken as a whole, the evidence indicated to me that the defendants, including particularly Mr. Rozette and Mr. Khoury,

faced some very difficult problems during the class period and that in each instance they sought to resolve these problems in a reasonable manner, make appropriate book-keeping records of their transactions, and make such disclosures in their releases to stockholders and the public as were indicated under the circumstances.

As a matter of hindsight, some of the actions taken on behalf of the company may have been unwise or imprudent or even inept. And if the fraudulent intent that the plaintiff sought to ascribe to the defendants had been established, such actions might have been attributed to a furtherance of such intent. However, in the absence of a sinister motive or culpable recklessness, neither of which was present here, these actions do not constitute a basis for relief in a 10b-5 law suit, in light of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Under these circumstances, the issues that

were litigated so exhaustively at the trial become reduced to questions of policy, or wisdom, or "GAAP" or even negligence, and it is unnecessary and inappropriate for this court to express its views concerning them.

With respect to the counterclaim against Mr. Catena, I think that an insider that makes a short sale of the stock of his company just before its price begins to go down lays himself open to the inference that he has done so on the basis of inside information. But I am not convinced that such inference, without more, is a sufficient basis for a judgment on the counterclaim. I am also impressed with the plaintiff's argument (Reply Brief at page 388) that if he had been utilizing inside information, he probably would have waited longer to cover the sale and thus increase his profit.

This Memorandum shall constitute findings of fact and conclusions of law, as provided in Rule 52 of the Federal Rules of

Civil Procedure.

Judgment for the defendants on the complaint and for plaintiff Catena on the counterclaim is being entered contemporaneously herewith. The defendants are entitled to recover their costs.

DATED: April 5,1978.

/s/ William P. Gray
WILLIAM P. GRAY
United States District Judge

SECTION 10b

SEC. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange - ...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

RULE 10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Rule 803(6), FEDERAL RULES OF EVIDENCE

(6) Records of regularly conducted activity. A memorandum, report, record, or data compilation, in any form, of acts, events, conditions, opinions, or diagnoses, made at or near the time by, or from information transmitted by, a person with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record, or data compilation, all as shown by the testimony of the custodian or other qualified witness, unless the source of information or the method or circumstances of preparation indicate lack of trustworthiness. The term "business" as used in this paragraph includes business, institution, association, profession, occupation, and calling of every kind, whether or not conducted for profit.

Rule 52(a)
FEDERAL RULES OF CIVIL PROCEDURE

(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).

PRIVATE
MEMORANDUM

September 2, 1972

To : J. D. McMenamin

From : N. A. Erickson

Subject: Capitol Industries, Inc.

It seems prudent at this time to reduce to writing some thoughts regarding the relationships developed between Capitol Industries, Inc. and ourselves during the examination of Capitol's consolidated financial statements for the year ended June 30, 1972. Towards the end of this examination certain working relationships were somewhat weak.

Background Factors

- Capitol Industries, Inc. and its subsidiaries quoted an $8 million loss for the year ended June 30, 1971, after reporting a $362,000 net income for the first nine months of that year. (At this point the underlying reasons seem to be weak bookkeeping and ?).

- With exceptions, executive management of Capitol has had a complete turnover and those responsible for the 1971 performance have left the company. One exception is in the finance area where Charles Fitzgerald was moved up from Corporate Treasurer to Vice President, Finance, and the EDP manager who is not an accounting type became corporate controller.

- Fiscal 1972 was anticipated to be a small profit or small loss year after about 4 high income or (1971) loss years. Therefore matters previously of small consequence became important.

- Fitzgerald (who is our principal executive contact) essentially identified with the 30% share ownership held by the U.S. public, not the 70% owned by EMI Limited. He is glib and clever. Essentially he was hostile to us from the beginning - possibly because we were appointed as auditors via EMI.

- Fitzgerald continually reminded us that the fee was to be minimized. His words were frequently harsh. He had had no experience with our firm on which to base such a posture.

- The deadline assigned was too fast (one month and four days after year-end). It was even more unreasonable when one considers the company's weak bookkeeping, and the facts that we were new auditors and the job took longer in 1971.

- Merco Enterprises, a rack-jobbing and record retailer headquartered on Long Island, was a basket case last year. Our predecessors finally issued a qualified opinion in the spring of 1972 for a fee of approximately $50,000. The Merco controller was fired in the spring of 1972. Fitzgerald wished, in fact for a time was adamant, that the internal auditors, not ourselves, were to conduct the Merco audit for June of 1972. (I finally cabled Corsan for help and we did the Merco audit - it went the smoothest of all.)

What We Found

- Company personnel are uninformed as to U.S. financial reporting and practices including those prescribed by the SEC. Further, Fitzgerald, who has given lip service to a willingness to learn, frequently expresses the point of view (many times for no apparent useful reason) that elasticity must be found in the rules to allow the company to do what they want.

- A provision for year-end surprises of $2,700,000.

- The inability of client personnel to perform timely and in accordance with a year-end closing timetable which they prepared. (However, I should note that client accounting people did try very hard.) For example, the report draft was due from the client without numbers in June. More than once we reminded appropriate client personnel of this and we finally saw it - presented to us in pieces - the middle of August. In another case, the client's machine trial balance was produced on the net income release deadline date, eight days after originally scheduled. Nevertheless, the client was not willing to permit us an extension equal in time to their tardiness.

- I noted <u>much</u> client dissatisfaction with us because of this. However, in most cases we were able to perform so that the delay caused <u>by the client</u> was partially compensated for by our speed.

- Fitzgerald is unaware of what goes on below him. Basically he manages by listening to and reading memos prepared by his subordinates, rather than exhibiting a posture of seeking out problems. Based on his inadequately informed position, he then issues instructions, which are not always susceptible to being accomplished.

  For example, I informed him that the company sales return policy and practice was "for credit" with respect to single records. He thought it was "for exchange." Also, the parent company had a $4 million book cash over-draft at year-end. In the latter half of August, Fitzgerald was surprised when I told him there was any overdraft at all - and, at the same time, the controller thought it was only a few hundred thousand. In another instance, when we presented him with the "A" schedules - these are the EMI subsidiary financial package used by EMI to consolidate in the U.K. - for signature, he advised our man "What are you guys, comedians? What am I supposed to do with these - I don't know what to review." Yet, not only are the schedules company responsibility imposed by EMI, they appear to be essentially the same as the "M" schedules prepared monthly by the company.

- Specious arguments supporting adamant company postures in several accounting and reporting matters. (See copy of our draft letter never issued - which draft had to be prepared in order to stimulate the client to change his mind - after orally reviewing most of the items with Fitzgerald (some more

than twice) without success.)

- The client was unwilling to say that certain subjective evaluations were complete until the day net income was finally calculated. These two areas (bad debts and inventory obsolescence) could have given us a further problem in client relations had they decided to change their original positions which we had audited. (Apparently, in spite of early declarations to the contrary, net income may have been a preconceived amount.)

- The client was making changes and providing for accounting adjustments at year-end which should have been done much earlier. (Interim financial reporting accuracy needs substantial improvement.) The most striking example is the formula used to compute reserve for record returns. This formula was originally developed very early in the fiscal year and the client stimulated change - with which I agree - was brought up and decided upon in July 1972.

- Several year-end adjustments had to be processed. Most were not stimulated by auditors' findings, but rather by the client as a result of the fact that this was a year-end closing as opposed to a monthly one. Excluding Merco (which is not available to me at this moment) these included:

  - Correction of the allocation of Audio product inventory variance to cost of sales resulted in an income charge of $300,000 (we originated).

  - Provision for loss of the New York

building resulted in an income charge of $3,467,000 (we originated).

- Provision for royalties payable to artists as a result of findings by the artists' auditors resulted in an income charge of $767,000.

- Increase in Capitol reserve for bad debts - $100,000 income charge.

- Increase in inventory for obsolescence at Capitol - $150,000 income charge (we originated).

- Adjustment to Capitol inventories regarding inventory variance $246,000 income charge (we originated).

- Reversal of excessive artists' advance allowance at Beachwood Music $100,000 income credit (we originated).

- Unrecorded sales in sales cutoff problem at Capitol $100,000 income credit.

- Bad debts and sales returns adjustments at Audio of approximately $150,000 income charge (we originated).

- Inadequate income tax historical analyses in the client's files.

- Many prior year credits in income for which the client found offsets.

- The client has an inexperienced and inadequately led internal audit staff. We were asked to make as much use as

we could of them by assigning them to complete audit areas, such as fixed asset addition work, and get involved only to the extent of reviewing their audit program and final work papers. The internal auditors appear to have adequate native intelligence. However, they lack the experience and leadership to perform in the way initially required by the client. In some cases we ended up spending almost as much field work time on the internal auditors' audit areas as if we had done the entire field work ourselves without any assistance from them.

- Erroneous accounting for the equity in income of the 25 per cent owned Japanese joint venture company.

Comments on Fault Finding

Where We Were Wrong

- I failed to become well acquainted with Bhaskar Menon, Capitol's president. David Corsan recommended this and after a few unsuccessful attempts (Menon was out-of-town frequently), I went on to other things. This was a serious error of omission which I hope to correct in the future. A line of communication here might have eliminated some of the misunderstanding.

- Through no fault of his, the audit manager got to the job late. As a result, some things which should have been done early in the engagement, for example income tax history analysis, were done late.

- Considering the deadline, the engage-

ment was understaffed in terms of numbers of people. The job was bigger than we thought. (Please note the client posture that our fee estimate should be based on the premise that accounting and bookkeeping at the companies was in perfect shape and continuing pressure to keep our fee low didn't help us to assess the situation objectively.)

- I let my temper get the better of me twice. With hindsight, I do not believe it was without provocation, but that doesn't make it right.

- I originally took the position on current income taxes that the words of APB Opinion No. 11 must be followed regardless of the result that the financial statement income taxes computed thereby would bear a strange relationship to pre-tax income. This position was carried all the way through Capitol executive management (and, I assume, to EMI leaders). The next day after discussion with you and Jack Kennedy, we agreed to go along with the client on the basis that to do otherwise would be providing guaranteed income in future years. (It should be kept in mind that Fitzgerald was forewarned orally by me several times on a timely basis that the income tax computation for financial statement purposes for the year was going to be a weird one due to the large capital gain, and low ordinary income and that such computation should not be made until all year-end adjustments were in. He ignored these warnings. However, it gave Angelo and I some comfort to hear, from Kennedy, that Phil Defliese would do it the way

Ang and I originally suggested.

- Subsequent to the resolution of the above tax matter, we got stuck on reconciling the revised income tax computation with the payable, deferred and expense accounts. It was our mechanical error, perpetrated at a most inopportune time.

Their Fault:

- The description of the effect of the accounting change on pre-extraordinary income became an "eleventh hour" issue. Responsible client officials had been advised several times that an adequate description of the effect of the change was required. This included my oral statement to the Board of Directors (Fitzgerald was present) that the words used in the press release were improper for utilization in the financial statement footnotes. Subsequent to this, when the client finally presented us with his draft of the financial footnotes, the words used were exactly those used in the press release.

- Several other reporting matters arose the last minute, essentially because we did not get the report draft until the last minute. Fitzgerald repeatedly listened to our suggestions and positions taken firmly but gently, and then would proceed to ignore them in preparing his next report draft. With hindsight, I believe that his posture here was to try to get us to forget about our suggestions because they would give the appearance of having been presented us late, when in actual fact they were originally presented

early in the report draft game - or even prior to the time any draft was presented.

- Consolidation schedules to be used in the UK were mailed off approximately one week late. The client was not only one week late in the basic preparation of these items, but the client prepared them with a substantial number of errors. To assign the tardiness responsibility to us is to assume we are magicians.

- The continual harsh posture of Fitzgerald regarding deadline and fee, without knowing the company's capability to support us was inexcusable.

* * * * *

My original goal on this engagement was to attempt to minimize displacement arising out of a change in auditors and, at the same time, do a good job. (It is obvious that we did a much more thorough audit than our predecessors - we were more complete in work scope and took appropriate stands in matters of accounting and report disclosure.) The engagement was staffed with extraordinary good Lybrand personnel who worked seven days a week from early in July to early in August in order to meet an unreasonably fast deadline. Angelo and I were provoked frequently by Fitzgerald, who was speaking from an almost completely uninformed position regarding how progress was being made or not made during the closing. He repeatedly ignored our suggestions, comments and positions.

It was a difficult engagement!

NAE:vcm

cc: Mr. Peter Watt - New York - w/enclosures
Mr.David Corsan - London - w/enclosures
Mr. T.G.R. Lawrence - London -
/enclosures

Supreme Court, U.S.
FILED
DEC 8 1980
MICHAEL RODAK, JR., CLERK

No. 80-708

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

ROCCO CATENA, *Petitioner,*

v.

CAPITOL INDUSTRIES, INC., ET AL., *Respondent.*

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

LATHAM & WATKINS
ALAN N. HALKETT
JOSEPH A. WHEELOCK JR.
PETER H. BENZIAN
JASMINA A. THEODORE
Of Counsel

MAX L. GILLAM
555 South Flower Street
Los Angeles, CA 90071
(213) 485-1234
Attorney for Respondents

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D.C.

QUESTIONS PRESENTED

1. Was the District Court's finding, unanimously affirmed by the Court of Appeals, that Respondents' alleged acts and omissions, if any, did not result from the requisite culpability required under Rule 10b-5 clearly erroneous?

2. Did the refusal of the District Court, affirmed by a unanimous Court of Appeals, to admit into evidence an "accountant's extraordinary memorandum" constitute reversible error?

TABLE OF CONTENTS

	PAGE
PRELIMINARY STATEMENT	1
STATEMENT OF THE CASE	3
REASONS WHY THE PETITION SHOULD BE DENIED	6
1. The Questions Of Law Under Rule 10b-5 Which Catena Purportedly Seeks To Raise Before This Court Are Illusory.	6
2. This Case Is An Inappropriate One In Which To Decide Whether Mixed Questions Of Fact And Law Of The Kind Involved Here Are Subject To The "Clearly Erroneous" Standard Of Federal Rule Of Civil Procedure 52(a) Because Catena Did Not Raise This Issue In A Timely Manner In The Court Of Appeals And, Indeed, Argued To The Contrary. Moreover, The Issue Is Not Sufficiently Important To Warrant This Court's Attention.	8
3. The Issue Sought To Be Raised With Respect To The District Court's Evidentiary Ruling On The "Accountant's Extraordinary Memorandum" Lacks Any Precedential Significance.	10
CONCLUSION	12

TABLE OF AUTHORITIES

CASES: PAGE

Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 (1976) 7

United States v. *Johnson*, 268 U.S. 220 (1925) 2

United States v. *Ortiz*, 422 U.S. 891 (1975) 8

STATUTES:

Federal Rule of Civil Procedure 52(a) 8

Federal Rule of Evidence 103(a) 11

Federal Rule of Evidence 803(6) 10, 11

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

No. 80-708

ROCCO CATENA, *Petitioner,*

v.

CAPITOL INDUSTRIES INC., ET AL., *Respondent.*

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PRELIMINARY STATEMENT

The fundamental flaw in the position of Petitioner ("Catena") is his mischaracterization of the two decisions of the courts below.[1] Once this mischaracterization

---

[1] It should be noted that subsequent to affirming the District Court, the Court of Appeals denied Catena's Petition For Rehearing En Banc.

becomes clear to this Court, it will be seen that the only real questions which Catena raises turn on the particular facts of this case and are of interest only to the parties to it.

In essence, Catena asks this Court to make a third review of the lengthy trial record to determine whether it can find what two previous courts have been unable to find — *i.e.*, proof of some culpability on the part of Respondents[2] sufficient to render them liable under Rule 10b-5. This Court has ruled in the past that such a factual analysis is not a task to be served by a grant of certiorari. *United States* v. *Johnson*, 268 U.S. 220, 227 (1925).

At pages 4-28 of his Petition, Catena sets forth his contentions concerning the merits of the case. In substance, these contentions are identical to the ones he pressed in both the trial and appellate courts below and which were rejected by both such courts. These contentions, which focus solely on the evidence which Catena believes is most favorable to his position, are rife with factual inaccuracies and exaggerations; such contentions do not even purport to deal with the evidence presented by Respondents and which the District Court found persuasive. Respondents will not burden this Court with a refutation of these factual contentions.[3] In light of the fact that four judges have already rejected them,

---

[2] Petitioner correctly lists the names of Respondents in footnote 1 of his Petition with the exception that "William P. Rozette" should read "Walter P. Rozett".

[3] One example, however, should suffice to illustrate the point. At pages 10-13 of his Petition, Catena argues that Respondents knowingly employed an erroneous method of accounting for sales returns and that this method resulted in a substantial overstatement of Capitol's reported earnings. Catena fails to mention, however, that Respondents' expert witness at the trial and two independent

Respondents are confident that this Court, in determining whether the writ should issue, will take them with the pound of salt they deserve.

STATEMENT OF THE CASE

After voluminous discovery which continued almost without interruption for over three and one-half years, the trial in this matter commenced on September 30, 1975, and consumed approximately 58 days. In the course of the trial, testimony was received from 30 lay and expert witnesses — testimony reflected in approximately 8,000 pages of record. In addition, approximately 800 exhibits were received into evidence and considered by the District Court. At the conclusion of the trial, the parties submitted detailed post-trial briefs largely devoted to an intensive analysis of the facts presented by the testimonial and documentary evidence. A large portion of this evidence was directed to the extremely complicated bookkeeping, accounting, sales, inventory, and other policies, practices, and problems endemic to the industry of which Respondents were a part.

In rendering its opinion, the District Court first addressed itself to the primary contention which Catena had made over and over again from the inception of the case:

> "The plaintiff's case is based primarily upon the contention that the defendants engaged 'in a com-

---

auditing firms prior to the commencement of this litigation opined that the accounting method employed by Capitol for sales returns was perfectly appropriate. (Exhibit 21B at 12 and 18; Exhibit OR-20 at 4; Exhibit 448 at 1; R.T. 5014-5017 and 7833) Nor does Catena mention that, contrary to his contention, Respondents presented evidence at the trial that the use of the accounting method espoused by him, as opposed to the one employed by Capitol, would not have resulted in any dramatic difference in Capitol's reported earnings. (C.T. 3003-3022; Exhibit SCH-4; Exhibit OR-20 at 4-5; R.T. 2779-2783, 3623, and 6723-6731)

> mon course of fraudulent conduct designed for one central purpose, i.e., to misrepresent the operating results of [Capitol Industries, Inc.] so as to artificially inflate the market price of Capitol common stock.'" (Appendix to Petition at 7)

The District Court then stated its conclusion with respect to Catena's primary contention:

> "The basic trouble that I have with the plaintiff's case is that I am unable to conclude from the evidence that any such fraudulent purpose has been established." (*Id.*)

The District Court did not stop there, however. Not only did it find that there was no "fraudulent purpose" or, in other words, intentional misconduct involved, but it also found that Respondents' conduct could not be characterized as reckless in nature. On the contrary, such conduct could only be characterized, *at most*, as "unwise or imprudent or even inept". The District Court further found that Respondents had made "appropriate bookkeeping records of their transactions, and . . . such disclosures in their releases to stockholders and the public as were indicated under the circumstances." (*Id.*, at 11)

Catena, therefore, completely mischaracterizes the opinion of the District Court when he attempts to persuade this Court, in the same manner that he unsuccessfully tried to persuade the Court of Appeals, that the District Court had found only that there was no "fraudulent purpose" involved and that reckless conduct was not a sufficient predicate upon which to base liability under Rule 10b-5.

In the same manner, Catena now also mischaracterizes the decision of the Court of Appeals. According to that court,

> "The district court found that the conduct of appellees was based on good faith judgments, which, as a matter of hindsight, may have amounted to, at most, negligence." (*Id.* at 2)

The Court of Appeals then turned its attention to Catena's attack on this finding:

> "Catena challenges as clearly erroneous the court's finding that there was no more than negligence." (*Id.* at 2-3)

The Court of Appeals concluded that, contrary to Catena's assertion, the District Court's conclusion on this score was not clearly erroneous. Thus, the statement in the Petition that "the Ninth Circuit's affirmance must be taken to mean that there can be no liability under Rule 10b-5 unless it is first shown that a defendant possesses a sinister motive or a fraudulent purpose" is a total mischaracterization.

Once this Court preceives Catena's mischaracterization of the opinions below, it must conclude, we respectfully submit, that what Catena is really attempting to do here is to persuade this Court to review again the conclusions the District Court drew from the voluminous testimonial and documentary evidence at the trial and to draw conclusions from that evidence favorable to Catena. This task is obviously an inappropriate one for this Court to undertake.

REASONS WHY THE PETITION SHOULD BE DENIED

1. The Questions Of Law Under Rule 10b-5 Which Catena Purportedly Seeks To Raise Before This Court Are Illusory.

The two questions of law under Rule 10b-5 which Catena purportedly seeks to raise before this Court have been framed by him in the first two paragraphs of his Questions Presented:

> "1. Where a public reporting company recklessly misrepresents or omits to state material facts to the investing public, does liability arise under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and if so, do defendants' professions of 'good faith' constitute a defense to such reckless reporting practices?
>
> "2. Where a public reporting company knowingly or recklessly misrepresents or omits to state material facts to the investing public, does proof that the officers and directors of that company acted in 'good faith' in managing the company's affairs insulate the company and its officers and directors from Rule 10b-5 liability to purchasers of the company's common stock?"

These two questions of law are illusory. In the first place, each question assumes a fact which the courts below found to be false — namely, that Respondents were guilty of reckless misrepresentations or omissions. In the second place, Respondents have never contended, and neither of the courts below held, that professions of "good faith" constitute a defense to "reckless reporting practices." In like manner, Respondents have never contended, and neither of the courts below held, that "good faith" in managing a company's affairs insulates the company and its officers and directors from Rule 10b-5

liability even though the company knowingly or recklessly misrepresents or omits to state material facts to the investing public.

What the courts below did hold was that Respondents' conduct, both in managing Capitol's affairs *and* in reporting such affairs to the investing public, were *at most* negligent and that, therefore, under *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), Respondents could not be held liable under Rule 10b-5. Therefore, in claiming that the courts below rejected "recklessness" as a degree of culpability requisite for liability under Rule 10b-5, Catena has mischaracterized the opinions of both courts. In fact, Catena impliedly admits this mischaracterization in another portion of his Petition when he states:

> "A critical issue in this case was whether Capitol's alleged misconduct constituted actionable recklessness within the meaning of Rule 10b-5. With little elaboration, the District Court found that it did not." (Footnote and citation omitted) (Petition at 55)

This being the case, the decision of the Court of Appeals with respect to which review is being sought here does not, contrary to Catena's assertion, create a conflict among the Circuits because the two substantive issues which Catena claims are the basis of the alleged conflict are illusory.

2. This Case Is An Inappropriate One In Which To Decide Whether Mixed Questions Of Fact And Law Of The Kind Involved Here Are Subject To The "Clearly Erroneous" Standard Of Federal Rule Of Civil Procedure 52(a) Because Catena Did Not Raise This Issue In A Timely Manner In The Court Of Appeals And, Indeed, Argued To The Contrary. Moreover, The Issue Is Not Sufficiently Important To Warrant This Court's Attention.

At pages 54-60 of his Petition, Catena argues that the Court of Appeals erred in applying the "clearly erroneous" standard of review under Federal Rule of Civil Procedure 52(a) to the District Court's finding that Respondents' alleged misconduct did not constitute actionable recklessness within the meaning of Rule 10b-5. Not only did Catena fail to raise this "standard of review" issue in the Court of Appeals in a timely manner,[4] but, as indicated by the following sentence from ~~the~~ its opinion, he tacitly acknowledged the correctness of the standard of review which he now attempts to criticize: "Catena challenges *as clearly erroneous* the court's finding that there was no more than negligence." (Emphasis added) (Appendix to Petition at 2-3) Under these circumstances, this Court should apply its normal rule that it will not consider questions which are not raised by the petitioner below. See *United States* v. *Ortiz*, 422 U.S. 891, 898 (1975)

Even were Catena not precluded from raising the issue, the fact still remains that the issue concerning the

---

[4] After arguing before the three judge panel of the Court of Appeals that the District Court's finding was "clearly erroneous", Catena first challenged the correctness of this standard of review in his Petition For Rehearing En Banc.

appropriate standard of review which he seeks to raise here is not sufficiently important to warrant this Court's attention. It is not surprising that Courts of Appeals have struggled from time to time with the issue of the standard of review accorded to mixed questions of fact and law. This case, however, hardly presents the opportunity to clarify that issue.

The finding of the District Court which Catena contends was subjected to an erroneous standard of review by the Court of Appeals is the finding that no "actionable recklessness" was involved in this case. As Catena notes, "[r]ecklessness has traditionally been defined as highly unreasonable conduct accompanied by a conscious indifference to the consequences." (Petition at 38) It may be that the two elements of this definition — "highly unreasonable conduct" and "conscious indifference" — are properly subject to two different standards of review, since the latter element involves state of mind while the former does not. At any rate, no matter how this issue should be resolved, an opinion by this Court on this issue of appellate procedure would hardly provide a blueprint by which Courts of Appeals could determine what standard of review should be applied to the often multi-faceted and complex mixed questions of fact and law which come before them.

Accordingly, even if Catena had not waived this point in the Court of Appeals, the issue is not of sufficient importance to warrant this Court's attention.

3. The Issue Sought To Be Raised With Respect To The District Court's Evidentiary Ruling On The "Accountant's Extraordinary Memorandum" Lacks Any Precedential Significance.

The final issue which Catena seeks to raise here is whether the District Court erred in excluding a document characterized by the Court of Appeals as an "accountant's extraordinary memorandum" on the grounds that it did not fall within the so-called "business records" exception to the hearsay rule codified in Federal Rule of Evidence 803(6).

The document in question is a "Private Memorandum" prepared by a partner at Coopers & Lybrand eight months after the end of the class period involved in this litigation. As it indicates on its face (Appendix to Petition at 18-28), its genesis was a personality conflict between its author and the then Vice President Finance of Capitol, whom the author of the memorandum viewed as someone who identified with Capitol's minority shareholders and was "hostile" to Coopers & Lybrand from the beginning, possibly because Coopers & Lybrand had been appointed "via EMI", Capitol's majority shareholder.

Based on these considerations, the District Court stated:

> "It is one thing to call for the work papers. It is one thing to call for the formal report. Those things are prepared with some care, with the thought that they would be part of the record, and a tangible memorandum of the work of the company.
>
> "It is another thing for one partner to make a memorandum, perhaps off the top of his head, perhaps in white heat, perhaps with a shortcut of communication, that he does not view as con-

stituting a permanent part of the record." (R.J. 4970)

Contrary to Catena's assertion here, neither the District Court in its ruling, nor the Court of Appeals in its affirmance, relied on any notion that, to be admissible under Federal Rule of Evidence 803(6), a business record has to be of a repetitive or routine nature. Rather, their rulings were based on the unusual nature of the "accountant's extraordinary memorandum" in question and the circumstances surrounding its preparation, both of which strongly indicated that the document had not been prepared with the safeguards which Congress had in mind in promulgating the Federal Rules of Evidence. Thus, viewed in proper context, the resolution of this evidentiary issue would only be of potential significance to the parties to this litigation; it would not provide any precedential significance with respect to the scope and meaning of Federal Rule of Evidence 803(6).

Moreover, whether such a ruling would even be of significance to the parties to this litigation would depend on this Court's resolution of yet another issue which it would have to face if it concluded that the District Court had erred in excluding the document. That issue would be whether the District Court's erroneous evidentiary ruling constituted reversible error because it affected a "substantial right" of Catena within the meaning of Federal Rule of Evidence 103(a). This latter issue would be difficult to resolve in Catena's favor in light of the District Court's statement at the time of its ruling that, if the "accountant's extraordinary memorandum" were to be admitted into evidence, "the effect on the Court's judgment would be miniscule. . . ." Since in light of that statement this Court would probably feel compelled to hold that there was no reversible error, its discussion of

the correctness of the evidentiary ruling in question would be an academic exercise of no precedential significance.

CONCLUSION

As demonstrated above, the issues which Catena has tendered to this Court are either nonexistent or unworthy of this Court's attention. Respondents submit, as a result, that the Petition should be denied.

Respectfully submitted,

MAX L. GILLAM
555 South Flower Street
Los Angeles, CA 90071
(213) 485-1234

Attorney for Respondents

LATHAM & WATKINS
ALAN N. HALKETT
JOSEPH A. WHEELOCK JR.
PETER H. BENZIAN
JASMINA A. THEODORE

Of Counsel

Dated: December 2, 1980

Docket No. 80-708

In the Supreme Court of the United States

OCTOBER TERM, 1980

ROCCO CATENA, on behalf of himself and the Certified Plaintiff Class,

Petitioner,

vs.

CAPITOL INDUSTRIES, INC., et al.,

Respondents.

Reply Brief In Support of Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

DAVID B. GOLD, ESQ.
PAUL F. BENNETT, ESQ.
GEORGE DONALDSON, ESQ.
JOHN W. ALLURED, ESQ.
DAVID B. GOLD, a Professional Law Corporation
120 Montgomery St.,
Suite 650
San Francisco, CA 94104
Telephone: (415) 981-2440
and
EDITH S. NEWMAN, ESQ.
Attorneys for Petitioner on behalf of himself and the Certified Plaintiff Class

BORG PRINTING COMPANY OF CALIFORNIA, 345 FIRST STREET, SAN FRANCISCO 94105

TABLE OF CONTENTS

		Page
I	PRELIMINARY STATEMENT	1
II	ARGUMENT	3
	A. Respondents Erroneously Contend that the District Court Found Their Conduct to be Negligent	3
	B. Petitioner Did Not Waive His Standard of Review Argument	8
III	CONCLUSION	10

TABLE OF AUTHORITIES

Cite	Pages
Ernst & Ernst v. Hochfelder 425 U.S. 185 (1976)	2, 5, 8
Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978)	7
Securities Exchange Act of 1934	
§10b	1, 5, 6, 8

PETITIONER'S REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

I

PRELIMINARY STATEMENT

Respondents do not dispute that a conflict exists between the Ninth and Second Circuits concerning the standards for recklessness liability under §10(b) of the Securities Exchange Act of 1934 and its amplifying regulation, Rule 10(b)(5). Nor do they contend that the questions presented on this issue are unimportant. Instead, Respondents argue that a writ of certiorari should not be granted because Petitioner has mischaracterized the opinions below, thereby rendering "illusory" the questions presented on the issue of the standard of recklessness liability.

In this Reply Brief, Petitioner demonstrates that if there has been any mischaracterization of opinions, it is Respondents' treatment of the district court's opinion.

The district court plainly did not find, as Respondents assert, that the conduct challenged by Petitioner was not actionable because Respondents only acted negligently. What the district court found was that Respondents did not act with a "fraudulent intent" and thus could not be liable under this Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). In light of that finding, the district court deemed it inappropriate to even consider whether Respondents' conduct could be characterized as negligent.

This legal ruling, which was affirmed by the Ninth Circuit, is completely at odds with the position of the Second Circuit, and there is nothing in Respondents' brief that even suggests otherwise. Accordingly, we respectfully submit that this Court should review this issue because it is one of major importance affecting the proper enforcement of the federal securities laws.

Respondents also admit that a conflict exists among the circuits respecting the standards for appellate review of a finding of recklessness. They claim, however, that this Court should not review the question because Petitioner "waived" it below and because the issue is, in any event, unimportant. As we will show, the claim of "waiver" is sham, and the issue is certainly important enough for this Court's consideration and clarification.

II

ARGUMENT

A. Respondents Erroneously Contend That the District Court Found Their Conduct to be Negligent

In the course of complaining that Petitioner has mischaracterized the opinions below, Respondents assert that the district court made an express finding that Respondents acted negligently in connection

///

///

with the challenged conduct.* Respondents'

---

* Respondents also assert that Petitioners' statement of facts is "rife with ... inaccuracies and exaggerations." Respondents' Brief at 2. After making this bald statement, Respondents offer little evidence of these alleged inaccuracies, claiming instead that they do not wish to burden the court with a refutation of these factual contentions. In the one example they do cite, (footnote 3, page 2 of Respondents' Brief) it is asserted that Respondents' expert and two independent auditing firms "opined that the accounting method employed by Capitol for sales returns was perfectly appropriate." That statement is simply not correct. No expert, including the one called by Respondents, opined that the method employed by Capitol was within even the framework of generally accepted accounting principles. In fact, Respondents' own expert admitted that the method urged by Petitioner would have been preferable to that actually employed by Capitol during the class period. R.T. 7889-7893; R.T. 9337-9340. Similarly, the contention that "two independent accounting firms" endorsed Respondents' sales return policy is totally lacking in factual support or judicial finding. See, e.g., Ex. OR-20. (For a complete discussion of these factual matters, the Court's attention is directed to Plaintiff's Post-Trial Reply Brief, Vol. I, at pp. 79-82.)

Irrespective of this particular factual dispute, we believe it is important to note what Respondents do not dispute, which is that they reversed millions of dollars from reserves to income without any public disclosure. This, of course, is one of the key issues in the case, and nowhere in Respondents' brief do they deny that this conduct occurred.

Brief at 7. In fact, the district court specifically refused to consider this issue because it found that "in the absence of a sinister motive or culpable recklessness, neither of which was present here, these actions do not constitute a basis for relief in a 10(b)(5) lawsuit in light of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Under these circumstances, the issues that were litigated so exhaustively at the trial become reduced to questions of policy, or wisdom, or 'GAAP' or even negligence, and it is unnecessary and inappropriate for this court to express its views concerning them." App. at 11-12.

Similarly, Respondents' assertion that the district court found that there "conduct could not be characterized as reckless in nature" is also incorrect. Respondent's Brief at 4. As the portion of the opinion quoted above clearly shows, the district court found that Respondents did not act with "culpable recklessness." Although it

is understandable that Respondents would like to ignore the qualifying adjective -- "culpable" -- it cannot be ignored if the decision below is to be properly understood. The plain meaning of the phrase "culpable recklessness" is that there is one form of recklessness that results in liability (i.e., "culpable recklessness"), while other forms of recklessness do not (i.e., "non-culpable recklessness"). Under the district court's view, what distinguishes actionable or culpable recklessness from non-actionable or non-culpable recklessness is the defendant's state of mind. Stated in another way, reckless conduct viewed objectively is not sufficient to impose Rule 10b-5 liability; there must also be a threshold finding of a "sinister" or "fraudulent" state of mind.*

---

* In affirming, the Ninth Circuit endorsed the concept of "culpable recklessness." App. at 3.

As we pointed out in our Opening Brief, this standard of recklessness liability, which was explicitly affirmed by the Ninth Circuit, is radically different from that of the Second Circuit, which has held that recklessness is to be viewed objectively and without regard to defendants' "good faith" intentions. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 n.15, 47 (2d Cir. 1978). There is simply nothing in Respondents' brief that disputes this conclusion.

Finally, it is significant that Respondents do not dispute the importance of this issue. As we pointed out in our Opening Brief, Section 10(b) is the only practical remedy for "open market" purchasers of the stock of public reporting companies. In these circumstances, where the integrity of the securities markets is dependent upon the investing public's trust and confidence, it is essential that consistent, objective standards be established for imposing Sec-

tion 10(b) liability. We submit that the integrity of the securities market is and will continue to be threatened so long as uncertainty exists respecting the remedies available to those who purchase. As we have shown, the conflict and confusion that presently exists with respect to the standards of recklessness liability are a direct result of this Court's decision in Ernst & Ernst v. Hochfelder, supra. We respectfully ask this Court to clarify this decision and eliminate the present conflict among the circuits.

B. Petitioner Did Not Waive His Standard of Review Argument

With respect to Petitioner's question relating to the standard of appellate review on a finding of recklessness, Respondents implicitly admit that the circuits are in conflict. Respondents' Brief at 9. They argue, however, that the issuance of a writ of certiorari to review this issue would be improper because Petitioner "waived" the

issue below and because this issue is unimportant. Respondents' Brief at 8-9.

The claim of waiver is pure sham. In Petitioners' Opening Brief on appeal to the Ninth Circuit, he pointed out that the appeal involved a dispute concerning the legal effect of facts to which the clearly erroneous rule did not apply. Opening Brief at 8, n*. Moreover, when the Ninth Circuit ruled that there were mixed questions of law and fact and then incorrectly applied the clearly erroneous standard, Petitioner immediately moved for rehearing on this issue. Obviously, therefore, Petitioner did not "waive" the issue.

As for the importance of the issue, we point out that the question we presented arises in the context of the appellate review of all securities cases involving mixed questions of law and fact such as recklessness. Moreover, these mixed questions arise in numerous other contexts, e.g.,

discrimination cases. Thus, this Court's decision will have wide applicability. Moreover, a consistent appellate approach to reviewing these questions (which does not presently exist) is essential to the uniform application of laws. In sum, the issue is certainly important enough for this Court's consideration and clarification. The writ of certiorari should accordingly issue.

III

CONCLUSION

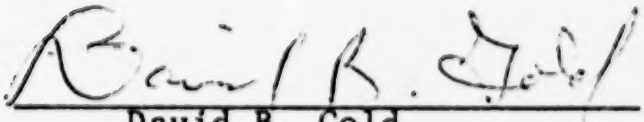
For the reasons stated in this Reply Brief and in our Opening Brief, the writ of certiorari should be granted.

Dated: December 16, 1980

David B. Gold
A Professional Law Corporation

and

Edith S. Newman



David B. Gold